RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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August 12, 1981 **LETTER 815**

July 31, DJIA 952.34; PTI 1477; A-D Ratio –19.04
Aug. 7, DJIA 942.54; PTI 1475; A-D Ratio –19.13

THE MARKET: One of the things I try to teach my subscribers is *patience.* The market has patience, carloads of it. One old Wall Street adage states, *"The market always does what it's supposed to – but never when."* Another adage runs, *"The graveyards of Wall Street are filled with the bodies of men who were right too soon."* In other words, the market is almost always logical, but if you expect that logic to work instantly, or when it suits you and your investments, forget it! The market is always logical IN RETROSPECT, but that same market will do its damnedest to wipe you out when you operate on what you "think" is logical, news-oriented timing.

The D-J Averages signalled a primary bear market on July 2. Over a month has passed since the bear signal and (surprise) the market has not collapsed. True, many stocks are down from their July 2 levels and the A-D ratio (a proxy for all NYSE stocks) is down from the July 2 level – but no swoon, no big slide yet.

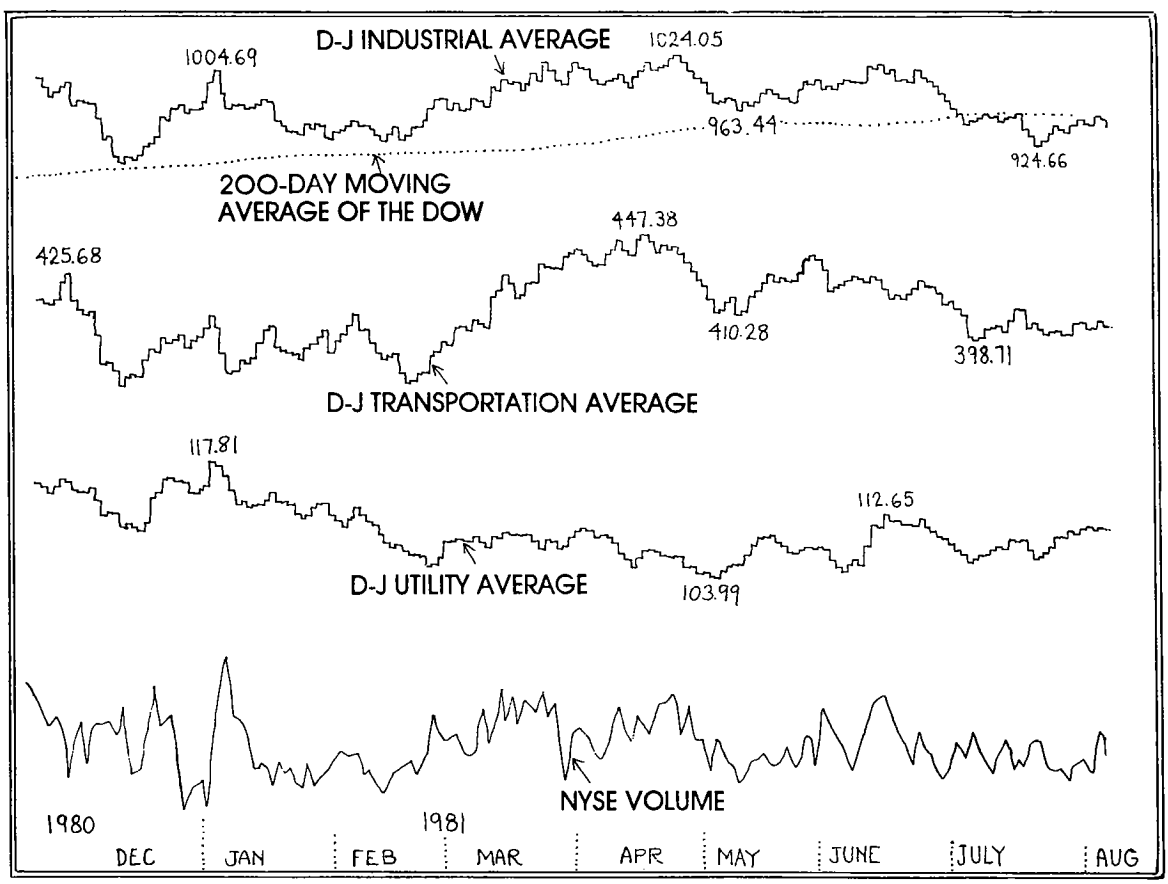
Downside resistance developed quickly following the bear signal. On July 7 the Transportation Average (see chart) recorded a low of 398.71. A few weeks later the Industrial Average (July 22) hit a low of 924.66. This Industrial low was unconfirmed by the Transports. Since then (through August 6) the Averages have been trying to rally – but the action has not impressed this writer.

Note on the page 2 chart that the A-D ratio, having hit a new low of minus 19.73 on July 23, rallied very sluggishly. The breadth of market on advancing days has been labored and unimpressive. On top of that, daily new highs on the NYSE since July 23 have never been more than 31, a dismal figure.

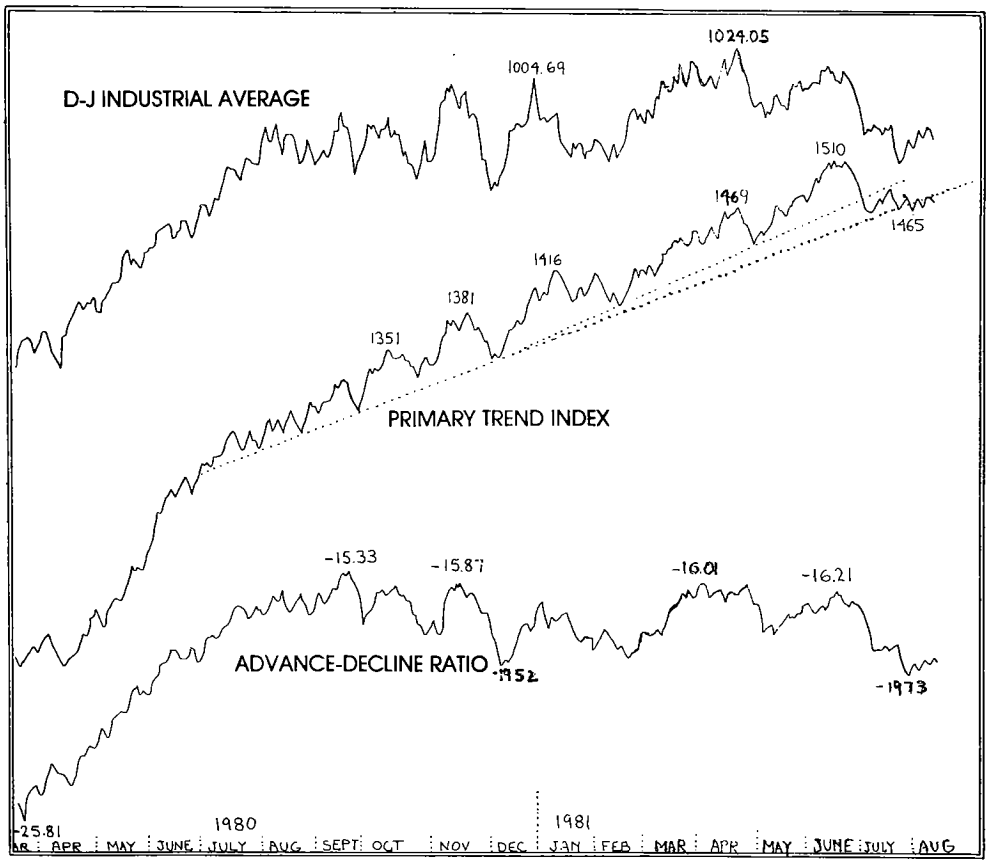
FRONT PAGE COMMENT: I've said it before (many, many times) but I'll say it again – the big story for 1981 is MONEY. The fruits of 40 years of deficit spending are now ripening, and those fruits consist of the greatest mountain of debt the world has ever seen ($5.8 trillion) – with the whole structure *compounding* at record high rates of interest! Here's a typical result. A few years ago the interest on the national debt was $60 billion a year. This fiscal year the interest on the national debt will be over $100 billion (or $2 billion a WEEK!).

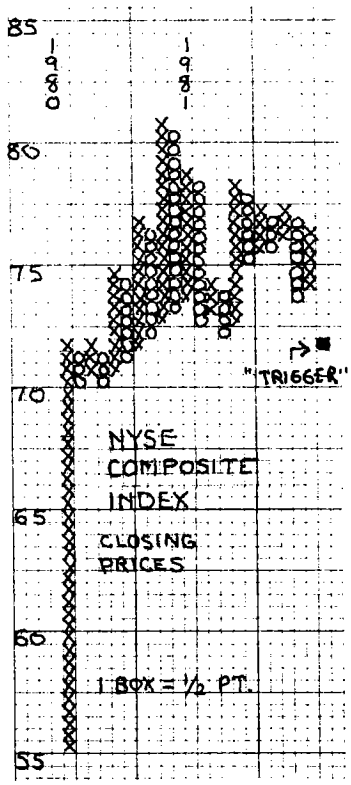
In Letter 813 I included an actual section from the Fed's flow of funds quarterly. Well, things are getting worse, and I estimate that the total amount of refinancing and new financing by the Treasury and the agencies (many of the agencies are on off-budget financing) could rise to an annual rate of near-$150 billion this year.

The build-up is sending the money markets into shock. It is scaring the dealers (who have to carry inventory) to death. It is an incoming tidal wave that could easily run interest rates to new record highs and beyond by year's end. It's a phenomenon that very few understand. Remember, it isn't a matter of cutting this or that or manipulating here or passing a new Congressional bill there. This is cold, hard debt coming due, and it'll be paid off or it's bankruptcy. What do you and I do about it? We stay OUT OF THE WAY by being in the safest, shortest-term, most liquid monetary vehicles – T-bills.



What about the Primary Trend Index (PTI)? What has it been saying over the past few weeks? Here, the story is a strange one, because the PTI has been engaged in a cliff-hanging act. The PTI recorded its high of 1510 (see page 2 chart) on June 23. A one-month decline took the PTI down to 1465 on July 6. Since then the PTI has been bouncing back and forth above and below the 13-month rising trendline – but so far, the PTI has not made a decisive move.





One minor observation: note on the chart above that although the Dow has been able to trace out a rally pattern from its July 22 (924.66) low, the PTI has moved sideways. It has refused to join the Dow rally. This could be a subtle hint of weakness. If the PTI won't rally when the Dow does, it could turn down when the Dow runs out of steam.

I use the PTI as an instrument to avoid whipsaws, to improve timing, and most importantly to help me identify the major trend of the market. Six weeks have elapsed since the June 23 high on the PTI. This is the *longest* period without a new PTI high since the whole rise began in early 1980. From the bulls' standpoint, it can be said that a bear signal has been given under Dow Theory but the PTI has not yet broken its rising trendline. From the bears' standpoint it can be said that six weeks have gone by without a new PTI high, and this amid a market that has been bulled by corporate takeover fever, a Reagan tax cut victory, and almost hourly predictions that interest rates are topping out.

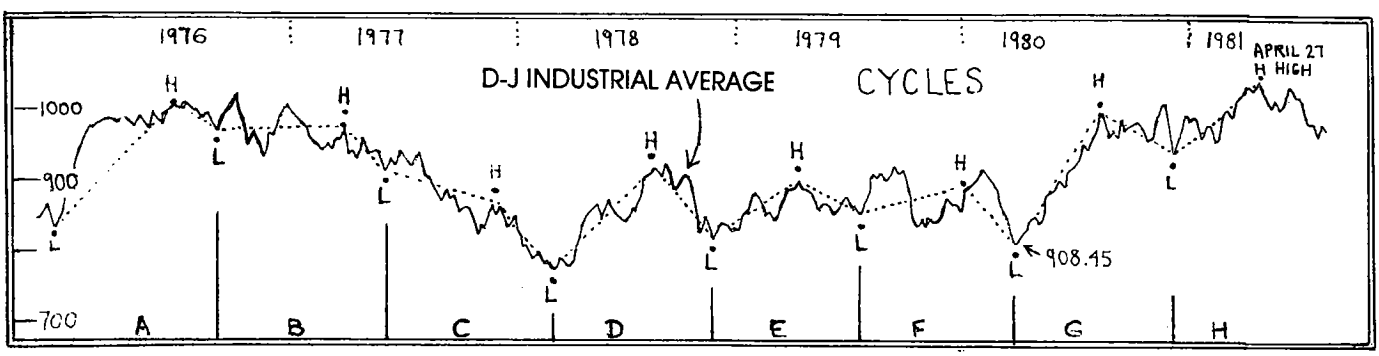
The PTI has a life of its own. Like Frankenstein's monster, I created it (the PTI) but I cannot control it, nor can I predict its actions. I watch it with the same fascination that my subscribers do, and I'm waiting (as you are) for it's next definitive prediction (see page 6 Late Notes).

The NYSE Composite Index topped out on November 28, 1980. Since then it has formed what appears to be a major top. This point & figure chart (above right) shows all the action since late-1980, and it also shows why I think the market has formed a top. But the test of a top is the decline that follows. And the signal for a completion of the top and the trigger for a potential decline is the box that I have filled in – the black box on the chart. This box would be operative IF the NYSE Index closed at 72 or lower.

In other words, any NYSE close of 72 would be expected to set off a major decline from the major "top area" that is pictured on the chart. Conversely, (and we always have to allow for a totally different opinion) if the NYSE can close at 78 we will have the first real hint that the structure is reversing to the upside.

THE 233 DAY CYCLE: (Chart below). Markets, like all living matter, must breathe. They inhale (rise) and exhale (decline). As readers know, I work with a 233-day cycle which I discovered some years ago, and I find that a study of this cycle can be most useful in drawing conclusions about the market trend.

I find that the 233-day cycle is most accurate when measured from one low to the next. The 233-day cycle is divided into



two parts, a 144-day rising segment and an 89-day declining segment (144 plus 89 equals 233).

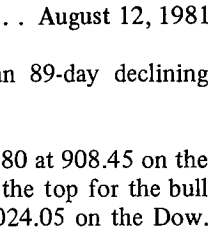
The last cycle low came on December 11, 1980 at 908.45 on the Dow. The new bull segment then began and the top for the bull segment (see chart) arrived on April 27 at 1024.05 on the Dow.

By my reckoning, the low for cycle H (the latest cycle on the chart) should occur around August 1-15.

The bull segment of the H cycle was weak. One manifestation of that weakness was the fact that the broad NYSE Index and the S&P topped out on November 28. Thereafter, the rising cycle failed to take these Averages to new highs. Moreover, the A-D ratio did very poorly during the bull segment of the H cycle, and at the April cycle high the A-D ratio failed to better it's last peak in August.

Looking ahead, we should soon be starting the new I cycle, and more specifically the bull segment of the I cycle. It will be very important to note how the market does during the coming bull segment of the I cycle. A reasonably strong market would be expected to take the Dow above the peak of the last (H) cycle at 1024.05 on the Dow. It should also give us a rising A-D ratio. But if these events fail to materialize, then we know that the market is basically weak, and that the coming bear segment of the current I cycle will almost surely take the Averages and the A-D ratio to new lows.

Conclusion: The period of August through January will contain the bull segment of the 233-day cycle. How the market does in this period will be most important in gauging the overall strength or weakness of the Wall Street picture.



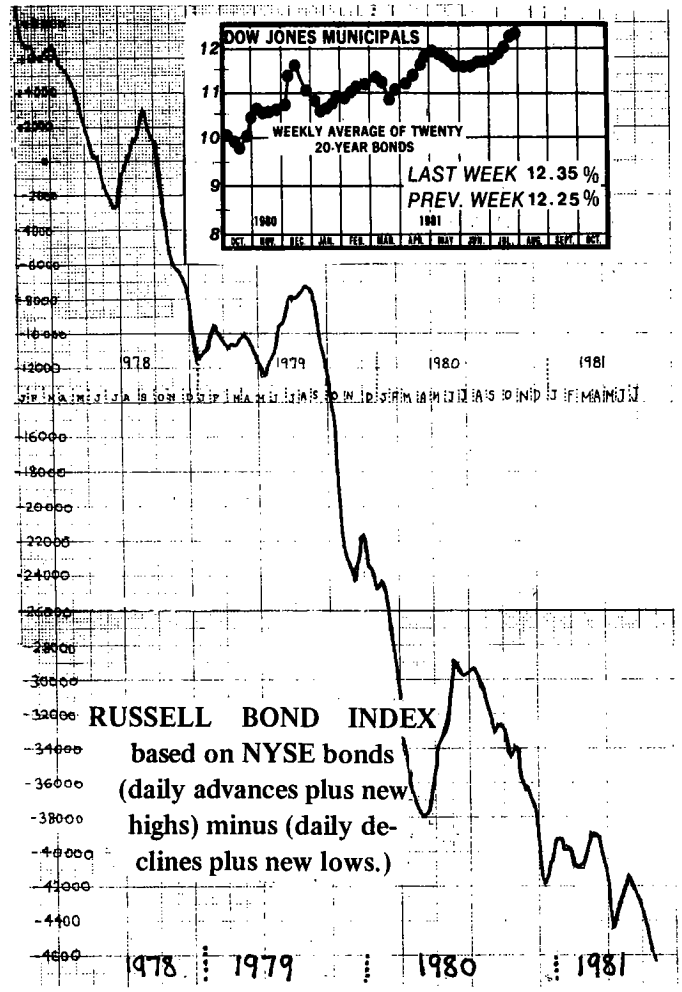
INVESTMENT POSITON: The bear is in this box, courtesy of the July 2 Dow Theory bear signal. On the basis of the bear signal and because I deem *capital preservation* to be the single most important investment consideration, I have directed subscribers to move into safe, high-yielding 91-day Treasury bills. The bills have looked good so far in 1981, and my guess is that before the year is out they'll look even better.

Subscribers who get antsy or semi-hysterical on every market rally will have to learn patience and fortitude. Real money is made over periods of months and years, not days and weeks. And that is a very hard lesson to learn.

MONEY: If it wasn't so pathetic, so insane, it would be comical. I'm talking, of course, about the torrent of "interest rates will be lower" predictions. Everyone from Treasury Secretary Regan to Merrill Lynch has gotten into the act, and that's really all it is – an act. You'd think the forecaster would show some sense of embarrassment, some shame. But no, on and on the hoping-game goes.

The problem is that when everyone's thinking the same, nobody is really thinking. Interest rates for years were a function of inflation. When inflation rose, bonds (which suffer from inflation) declined and interest rates advanced. When inflation declined, bonds rallied and interest rates receded.

So what's the added new ingredient that's making idiots out of the interest rate forcasters? The new ingredient is *illiquidity* and the surging, insistent, never-ending demand for money. Corporate



liquidity is now almost as low as it was in 1974, and Government demands are much, much more. Almost every Treasury auction now raises new money (as well as refinancing of old debt), and the bill, note and bonds markets are choking.

Since January bank C/D's have risen $7.2 billion. Since January commercial paper has risen $28 billion. This is a total of $35 billion so far this year in new credits and it's outdistancing the rise in the money supply. The result is a continuing squeeze in the money markets.

Last week the Russell Bond Index (see chart above) broke to an all-time low. The Russell Index is a broad advance-decline plus high-low count (daily) of ALL the bonds listed on the NYSE. It is an accurate measure of what's happening in the broad bond market. And what's happening is not good. I have inserted a *WSJ* chart showing what has been happening to Municipal bonds. Here we see (tax free) Muni yields rising to a record yield of 12.35%.

THE MONSTER: The US Government employs 2.8 million civilians and 2.1 million military personnel. Government on all levels (cities, municipalities, states) employs 18 million people or one out of every six working Americans. These 18 million people (who are paid either by taxes or loans) receive $832 billion a year in salaries.

The Federal Government now owes $966 billion. Next year it will owe $1.06 trillion. Next year the interest on the Federal debt will go over $100 billion. The Federal Government also guarantees $254 billion in loans. The Federal Government owns 413,042

buildings in the 50 states and overseas. It also owns 775 million acres of land – one third of the US land mass. The US Government is the nation's biggest user of energy, using enough energy to heat 11 million homes. The Government owns 449,591 vehicles and also leases others.

The Government utilizes the services of 67,235 clerks, 65,281 secretaries, 28,069 air traffic controllers, 27,504 computer specialists, 13,501 IRS agents, 5,771 economists, 5,479 voucher examiners, 3,208 psychologists, 16,467 attorneys, 38 undertakers, 519 civilian chaplains, 1,757 microbiologists, 658 landscape architects, 3,300 librarians, 8,092 carpenters, 66 saw sharpeners, 5 swineherds, 15 horse wranglers, and more.

Between 1961 and 1973 Washington produced 141 NEW agencies, over a third of the current total. None have been disbanded. In 1960 the Federal Government sent $7 billion to the states, today in 500 programs $88 billion goes to the states, cities and towns.

The Dept. of Health and Human Services estimates that in 1979 it blew $2 billion in overpayments or payments to ineligibles in three major welfare programs. It hopes to reduce this to around $1 billion.

In short, the Government of the US is still out of control. It is a monster, and of late it has become a sick monster. The average maturity on the Federal debt is now down to 3.8 years, and the average yield (cost) of this debt is over 11%. If the GNP fell 10% during a recession, the decline in Federal tax receipts would render the Government literally bankrupt (during the 1929 to 1932 period the GNP fell 50%).

Question: What would happen if we went into a severe recession? How would the Government pay off or service its debts?

Answer: Sooner or later, this will occur. At that time I believe that the Government would be forced to make massive cuts in its personnel and services. Huge new loans would have to be floated at perhaps "special interest rates" from the banks or from the public. All this would lead to huge liquidation of debt and mass bankruptcies. But the groundwork would be laid for eventual lower interest rates and a new stronger economy.

Question: Do you think the dollar could survive this kind of terrible liquidation?

Answer: I do, yes, but in this deflationary environment gold would take on new value, since gold (unlike the dollar) is not managed money – it's intrinsic money.

Question: Is there any way of avoiding this kind of ultimate bankruptcy?

Answer: Yes, through another kind of bankruptcy, namely hyper-inflation.

Question: Assuming the US goes through the deflationary scenario, what would Russia be doing?

Answer: Conceivably taking advantage of the US's misery by extending her influence. But there is also the strong possibility that Russia would be going through the same general problems herself.

Question: All right, Russell, now that you've scared me to death, what do I so to survive this coming Government fiasco?

Answer: I don't have any fixed answer. I have to see how things go, the severity of the situation, the politics, the timing. Right now I'm going on the hopeful assumption that the dollar can and will survive. But at a certain point I'm reasonably sure that we will have to go back into gold. I don't know now how much (what percentage) of gold, and a lot will depend on the way the gold pattern works out.

Question: What if the dollar collapses along with other paper currencies and gold is confiscated by the Government?

Answer: There is a certain point beyond which I refuse to worry. I mean, what if an asteroid hits the earth, what if Russia drops the bomb, what if Chinese frogmen appear off the West Coast. I operate on the assumption that life goes on. Despite what you may think, I'm a basic optimist. If I wasn't, I wouldn't have lived this long.

NOTES & QUOTES: I am a long-time student of the human mind (including my own) and longevity is one of the areas that fascinates me. I keep a scrapbook which includes notes and interviews about people who are over 100 years of age. I have observed that these people tend to have a number of things in common.

(1) They tend to be up-beat, optimistic. (2) They all seem to have a sense of humor. (3) They all have developed some kind of philosophy of life. Life seems to have a real meaning to them. (4) They are all interested in something, and they tend to think and live in the present. (5) They usually believe in God. (6) They tend to be on the small and the thin side. (7) They tend to be moderate in their eating and drinking, but some do drink, some do smoke, some do swear. (8) They like to watch things grow.

About the 8th, I think it is important to have an interest in something that is growing–and I'm not talking about your bank account. Gardening is the biggest hobby in the world, and with good reason. I grow Cacti (I have about 1,000 plants), and I find this hobby both fascinating and relaxing. Nothing pleases me more than some rare Cactus sending forth its exotic flower. Of course, I also have five children, ages 7 months to 25 years. But I don't care if you have a dog, orchids, kids, horses, peach trees or garter snakes, it is important and nourishing to grow something. I think it takes you out of yourself, and I believe that watching God's creatures (or plants) grow tends to keep *you growing as well*. Human beings are subject to the same law that governs all other living matter (except seeds and spores), you either grow or you die.

Incidentally, a fascinating and worthwhile new book on "how to grow very old" has just come out. The book stresses the mental approach and it's titled, "Psychological Immortality" by Jerry Gillies (Marek, $12.95). You too can buy IBM when you're 125!

* *

From an outstanding interview with author James Michener in the current issue of *Playboy*: *"The Russians are very much like us, and it's heartbreaking that we haven't been able to work something out with them. Right now, I see no possibility. The behavior of the Soviet state is monstrous. It's a society of delusions, lies, and repressions–and it shouldn't have to be that way. I think Russia may hold together for the next 40 years and then gradually begin to fragment."*

* *

A Russell Guess: OK, my guess is that the nation is going to be shocked to find that air transportation will do beautifully without the 15,000 air controllers. We'll find that like all other

Government areas, the Air transport area was overstocked with personnel. In six months the whole thing will be forgotten (although with maybe 75% of the flights going, airline earnings will be hit).

* *

From our Department of Non-Surprises:

> ***U.S. Postal Service Loss Is Wider Than Projected***
>
> *By a* WALL STREET JOURNAL *Staff Reporter*
>
> WASHINGTON–The U.S. Postal Service reported a $424 million deficit for the nine months ended June 30, after projecting a $68 million deficit for the period.

* *

The money markets have labored under a negative yield spread for over a year now. A negative yield spread occurs when short-term yields are above longer-term yields (normally, the further out the maturity, the bigger the risk and therefore the higher the yield). But a negative yield spread indicates pressure in the short-term market, and such pressure is never good for business.

Some of the results of the short-term pressure are becoming evident now. Demand for durable goods is plunging. The inventory to sales ratio is advancing to near-record highs, the real GNP is sluggish to falling. Housing starts have slumped to a rate of around 550,000 a year, auto inventory is way over 100 days supply (60 days is normal). Meanwhile, purchasing agents stated that conditions deteriorated in July with incoming orders, production levels and employment all dropping during the month.

In the last Letter I stated that the Administration along with the Fed mean to hammer the rate of inflation down, and they're willing to take a mild recession if that's necessary. All of which is generating the surprise syndrome: "Hey, I can't believe it, Reagan is doing what he said he would do in his candidate speeches. And the Fed is acting instead of talking!"

* *

With near-record interest rates and an honest Administration, the dollar is showing tremendous and persistent strength. The unabated collapse of major currencies (franc, mark, Canadian dollar, yen, etc.) is astounding observers. Yet all last year I wrote that in the period ahead "The dollar will be King." Now rumor has it that there will be devaluations in Europe. The French franc is a candidate for a 20% devaluation. The Canadian dollar has plunged to a 50-year low against the dollar. With socialist governments in both Canada and France, capital is seeking safety. And when capital flees, currencies fall.

CONSERVATION: I'm talking to my broker at EF Hutton. Unlike the Hutton ads, when the customer talks, he listens:

Russell: Well, what do you think of the tax cut, Ed? That's 5%, 10% and another 10% over the next three years. Not bad, huh!

Ed: Of course, with inflation it won't be quite that good either.

Russell: That's right, but suppose, just suppose there is deflation. With the 25% tax cut and a drop off in tax receipts, can you imagine what the shortfall in taxes to the Government would be? Can you imagine what the deficit would be? Can you imagine where the stock and bond markets would be?

Ed: I don't like to think about it.

Russell: Have you looked at the T-bill and T-note quotes recently? Turn to page 49 of the *WSJ*.

Ed: Gad, 1982 and 1983 T-notes at 16% or better. It's unbelievable!

Russell: That's right, and without state taxes they're worth even more. At these rates (16%) money doubles in LESS than 5 years. How in hell can the stock market compete with that kind of Government paper?

Ed: Boy, the whole deficit mess could really hit with a vengeance.

Russell: I don't like to think about it. By the way, how did you like the 50% ceiling on unearned income feature of the tax bill?

Ed: Beautiful, really beautiful.

Russell: I'll say. If I can keep 50 cents on every buck, that suits me. Who needs tax shelters or anything else when you can buy a note yielding over 16%, keep half or better and compound the remaining 8%. Hell, you're beating inflation – and taking no chances!

Ed: It's sad, but if this whole thing turns into a mess, they'll blame Reagan.

Russell: That's right, we should have had Reagan 20 years ago. Now he's inherited an illiquid nation, and if we fall apart it won't be his fault. He did what he could with an economy that was drowning in debt and short of capital.

* *

Every year the National Taxpayers Union shows statistics on US Government debits and credits. Here's the latest chart showing what the damn fools in Washington have been doing over the past 40 years. Since you and I are the public, the accounting pertains to us, and we have potential liabilities now of $138,223 for each and every one of us. Ever wonder why interest rates don't come down?

DEBT OR LIABILITY ITEM	GROSS COST	YOUR SHARE
Public Debt	$ 971,000,000,000	$ 12,137
Accounts Payable	$ 129,000,000,000	$ 1,612
Undelivered Orders	$ 452,000,000,000	$ 5,650
Long Term Contracts	$ 20,000,000,000	$ 250
Loan and Credit Guarantees	$ 321,000,000,000	$ 4,012
Insurance Commitments	$ 2,219,000,000,000	$ 27,737
Annuity Programs	$ 6,900,000,000,000	$ 86,250
Unadjudicated Claims International Commitments & other Financial Obligations	$ 46,000,000,000	$ 575
TOTAL	$11,058,000,000,000	$138,223

* *

THOUGHT FOR 1981: With average mortgage rates at 17% and the median house price at $66,400, 9 out of 10 prospective home buyers can't afford a home. New housing starts in previously booming San Diego County were down 27% in June.

* *

Atlantic City is no Las Vegas, since Atlantic City has only 7 casinos. But those casinos during the single month of June took in $91.9 million in gross profits or an average of $13.1 million per casino. This comes out to $436,000 per day in gross profits that the average Atlantic City casino took from the suckers. I include these Las Vegas, Reno, Atlantic City computations every six months or so in the hopes that my subscribers will understand

that gambling is just another way of giving away your hard earned, after tax money. The State of Nevada is the only state in the Union with no state or inheritance taxes. What does Nevada need state taxes for, the suckers from the other states pay the taxes for them – in the form of gambling losses.

GOLD: Hold it, could something important be happening to gold now; In Letter 813 I urged subscribers to be "completely open-minded about gold." Let's look at the picture with that same open mind.

(1) The gold average (see page 6 of last Letter) hit a low of 9.50 on June 30. After a rally, gold broke to a new low of 392, but the gold average refused to confirm on the downside. (2) Gold hit within a fraction of 388, the figure that Bob Prechter (Elliott Wave Theorist, see Letter 813) predicted according to Elliott would be the gold bottom. (3) Gold "experts" and former gold bulls are now openly predicting "200 to 250 for gold." (4) Without accompanying news, gold shares (ASA, HM) turned strong on August 6. (5) The Gold-to-Dow ratio is currently on its declining trendline. A price of 410 for gold with a 940 Dow would break the Gold/Dow ratio above its 11-month declining trendline (see chart in the last Letter). (6) Sentiment towards gold has turned sour to bored, as witness this article from last week's San Diego Union. (7) The gold bear market is 20 months old, it's becoming an old bear market.

Gold Rush Of 1979-80 Now Just A Trickle

By ELIZABETH BRAFFORD
Staff Writer, The San Diego Union

Lines of jewelry-laden customers no longer snake around the Old Coin Shop on El Cajon Boulevard. The five-gallon buckets of school rings are gone. And the signs ordering separate queues for gold buyers and gold sellers are in storage.

At this coin shop and others in San Diego County, the gold rush of late 1979 and early '80 is over, gradually halted by the steady decline in gold prices on the London, Zurich and New York markets.

Gold began slipping from its record high of $875 per troy ounce in January 1980 and now hovers around the relatively affordable $400 mark, but interest in buying the precious metal has plummeted.

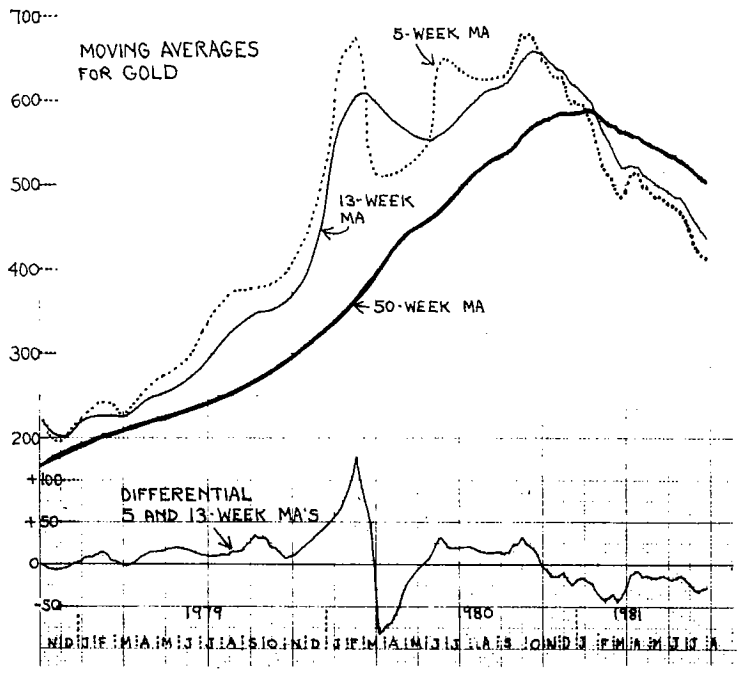
For San Diego merchants of gold jewelry and bullion, the standstill in gold prices means it is a buyer's market – a slow buyer's market.

Recently, with gold holding at slightly above $390 per troy ounce on the New York spot market, the Old Coin Shop had only one customer – and he was looking at silver.

In view of all this, I believe that initial positions in gold are warranted with the definite stipulation that all positions be jettisoned if gold bullion (spot) drops below 385. Remember this: nobody on this green earth knows whether 392 was THE bear market low for gold or not. If it was THE low, then any position in gold here (coins, options on gold shares, no-load gold funds such as United Services Fund) will turn out to have been bargains. But if 392 was just a stop-off to lower prices, then not too much will be lost in this low area.

NOW, what are the crucial tests for gold? One is the moving averages (MA's). I include my chart of the 3 gold moving averages, and note that the 3 are still in the bearish mode. The 5-week MA is at 405, the 13-week is at 432, and the 50-week is at 501. But note also that the differential between the 5 and the 13-week MA (bottom of chart) hit its lowest level in March of 1980, it recorded a higher minus level in February-March of 1981 and a still higher minus level in July. When the 5-week MA finally crosses above the 13-week MA, this differential will turn plus. It has not been plus since March of 1980. The first positive sign here would be a climb in spot gold above (holding above) the 5-week MA or above 405.

My gold momentum chart (13-week rate of change) is still negative at 82.5. It would take a rise to 94 to turn the declining momentum trendline around, and this has not happened yet. Nevertheless, gold is looking interesting here, and I am not adverse to taking "bottom picking" positions here.



LATE NOTES: The PTI lost 45 points in its decline from the June 23 high of 1510 (see page 2 chart) to the July 6 low of 1465. Since July 6, market rallies and declines have both been unimpressive as far as PTI figures are concerned. Nevertheless, a declining trendline can now be drawn from the June 23 high. How the PTI acts in respect to this trendline will provide us with critical market readings over the period ahead. Remember, the Dow Theory has already said–bear.

NEXT MAILING: August 26